1990

State and local governmental developments - 1990; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

CURRENT INDUSTRY DEVELOPMENTS

State and Local Governmental Developments – 1990

Update to AICPA Audit and Accounting Guide
Audits of State and Local Governmental Units

Includes *Audit Risk Alert – 1989*

Issued by the
Federal Government Division

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This document, which contains *State and Local Governmental Developments—1990* and *Audit Risk Alert—1989*, is intended to provide an overview of matters that may affect audits of the financial statements of state and local governmental entities, including recent economic and professional developments. This document has been prepared by the AICPA Government Accounting and Auditing Committee and the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Introduction

The pace of change in the governmental accounting and auditing sector over the past several years has been accelerating steadily and shows no sign of relenting. In addition, the recent focus on audit quality has highlighted the need for auditors to better understand the financial reporting standards that apply to governmental entities, as well as to keep abreast of the numerous and complex auditing and financial reporting problems that arise in the governmental sector. Auditors should also be aware of the changing political, economic, and social environments in which state and local governments operate.

Many changes in financial reporting standards have taken place recently, and more changes are expected as the Governmental Accounting Standards Board (GASB) continues to reexamine the overall standards for accounting and financial reporting by governmental entities. These changes, along with new AICPA auditing standards and new rules and guidance issued by the U.S. General Accounting Office (GAO), the U.S. Office of Management and Budget (OMB), and the President's Council on Integrity and Efficiency (PCIE), need to be considered in audits of state and local governmental entities. Some of the recent changes include the issuance of—

- Several new GASB pronouncements.
- AICPA Statement on Auditing Standards (SAS) No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance.*
- AICPA Statement of Position (SOP) 89-6, *Auditor's Reports in Audits of State and Local Governmental Units.* (This amends the AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units,* to conform with SAS No. 58, *Reports on Audited Financial Statements;* SAS No. 62, *Special Reports;* and SAS No. 63.)
- AICPA SOP 90-4, *Auditors' Reports Under U.S. Department of Housing and Urban Development's Audit Guide for Mortgagors Having HUD-Insured or Secretary-Held Multifamily Mortgages.*

According to a recent decision by the Financial Accounting Foundation (FAF), the GASB will retain its jurisdiction over all governmental entities, including so-called special entities, such as public colleges and universities, pension plans, utilities, airports, and health care facilities. Compliance with Financial Accounting Standards Board (FASB) statements and interpretations will not be mandatory for governmental entities unless the GASB specifically designates them as applicable in one of its own statements.

Because governments operate in politically sensitive environments, auditors need to be alert to the potential impact of mismanagement, defalcations, and noncompliance with laws and regulations. Many governments have adopted legislation on financial accountability and internal controls because of the increased public focus on the accountability of elected officials and government employees. These may include—

- Guidelines on conflicts of interest and ethics.
- Restrictions on the use of discretionary funds.
- Restrictions on travel and entertainment expenses.
- Restrictions on private use of publicly owned property (for example, automobiles).
- Restrictions on outside political activities.
- Lobbying restrictions.
- Disclosure requirements for recipients of federal funds.

Professional Standards

Depending on the amount and source of federal financial assistance received by a governmental entity, it may be required to satisfy audit requirements described in *Government Auditing Standards*—1988 revision, the Single Audit Act of 1984, SAS No. 63, other federal policies and regulations, and agreements or contracts with federal agencies.

Government Auditing Standards

Federal Inspectors General (IGs) are required by law to ensure that audit work conducted by nonfederal auditors of federal organizations, programs, activities, and functions complies with generally accepted government auditing standards as set forth in *Government Auditing Standards*. They include requirements for reporting on financial related audits, compliance with laws and regulations, and internal controls. Nonfederal auditors are required to follow these standards when required by law, regulation, agreement or contract, or policy.

The Single Audit Act of 1984 requires each state and local government that receives a total amount of federal financial assistance equal to or in excess of $100,000 in any fiscal year to have an audit made for that year in accordance with its requirements. Governments that provide federal grant funds to other organizations through a subgrant relationship are required to ensure that the subrecipient organization complies with the applicable federal audit requirements. Federal IGs have cited the lack of adequate audits of subrecipients as a problem area in audits conducted under the Single Audit Act

SAS No. 63 sets forth standards for testing and reporting on compliance with laws and regulations in audits conducted in accordance with generally accepted auditing standards, *Government Auditing Standards,* and the Single Audit Act of 1984 and addresses reporting on the internal control structure under *Government Auditing Standards.*

Various other federal policies and regulations, such as OMB circulars and related compliance supplements, and federal department audit guides or handbooks may contain applicable audit requirements.

Agreements or contracts between the audit entity and a federal department or agency may specify additional audit requirements.

Continuing Professional Education Requirements

Government Auditing Standards requires auditors responsible for planning, directing, conducting, or reporting on government audits to complete eighty hours of continuing professional education (CPE) every two years, with at least twenty to be completed each year. Of these eighty, at least twenty-four hours should be in subjects directly related to the government environment and to government auditing. Several issues relating to compliance with these requirements will be addressed in a forthcoming GAO staff interpretation of the CPE requirements. Auditors who perform audits in accordance with *Government Auditing Standards* after January 1, 1989, must meet the CPE requirements by January 1, 1991.

Peer Review Requirements

Government Auditing Standards requires audit organizations to establish an internal quality control system and participate in an external quality control review at least once every three years. Audit organizations that perform audits in accordance with *Government Auditing Standards* after January 1, 1989, must undergo this external quality control review by January 1, 1992.

Quality of Nonfederal Audits

In a recent semiannual report of the PCIE Standards Subcommittee on the quality of nonfederal audits reviewed by the IGs, the IGs cited significant reporting and auditing deficiencies that made the audit reports unsuitable for their purposes. The deficiencies included—

- Missing reports on internal controls, compliance, or both.
- Missing financial statements, including footnote disclosures or supplementary data.
- Inadequate documentation of the procedures performed in the auditors' workpapers.

The IGs also identified audit reports that required major changes because of deficient reporting language, including lack of the required comments by the auditor on the status of prior period audit findings.

The risks and ramifications to the auditor of issuing a deficient audit report or performing an inadequate audit are significant and include suspension from performing further audits of recipients of federal funds.

Specific Conditions or Risk Factors

This section describes certain conditions that may indicate (but do not necessarily confirm) the existence of increased audit risk. The listing of factors is not all-inclusive.

Higher Risk Federal Programs

The OMB recently issued a list of several major federal grant programs that have a higher risk of fraud and abuse and are subject to single audit coverage. These include—

- The Food Stamp program.
- Job Training Partnership Act programs.
- Mass transit grants.
- The Environmental Protection Agency Superfund program.
- Discretionary grants awarded by the U.S. Department of Education.

The OMB also listed the following conditions that, when present, cause a federal program to be at higher risk for fraud, waste, and abuse:

- Large numbers of transactions and cash flows
- Broad, inadequately supervised delegation of authority
- Excessively decentralized program execution
- Potential for physical or environmental damage
- Recent start-up or pending termination
- Inadequate attention to management by political leadership

Errors, Irregularities, and Illegal Acts

Government Auditing Standards, like SAS No. 54, *Illegal Acts by Clients,* requires that audits conducted in accordance with its standards include a test of compliance with those laws and regulations that have a direct and material effect on the determination of financial statement amounts. SAS Nos. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* and 54 require communication with the audit committee or others with equivalent authority regarding all irregularities and illegal acts except inconsequential ones. *Government Auditing Standards* and the Single Audit Act require written reports on compliance with laws and regulations in all audits. Additional guidance can be found in SAS No. 63.

The myriad of complex laws and regulations that apply to state and local governments increases the risk of noncompliance. Areas of noncompliance may include, for example, collateralization requirements for deposits and investments; investment restrictions; arbitrage regulations and rebate rules; and withholding, reporting, and remitting of payroll taxes. The auditor should assess whether management has identified the applicable laws and regulations.

Investments and Investing Activities

The following factors relating to investments may increase audit risk:

- Undocumented, unapproved, or inadequate investment policies, procedures, and controls
- Insufficient collateralization based on current market values
- Certain investments and investing activities, such as repurchase and reverse repurchase agreements, margin accounts, venture capital, securities with maturities in excess of short-term cash needs, securities with high rates of return and corresponding high market risk, and trading and "churning"

Guidance on disclosure of investment activities of governmental entities is contained in GASB Statement No. 3, *Deposits With Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements.*

Revenue Bond Defaults

There has been an increasing number of defaults on revenue bonds, the vast majority of which have occurred when actual revenues available for payments to bondholders were substantially less than budgeted revenues. Revenue shortfalls caused by a downturn in the local economy and declining or depressed real estate values may result in the inability of governmental entities to comply with bond provisions. The auditor should consider the adequacy of disclosure of default conditions.

Lease and Rental Arrangements With Public Authorities

Many governments have entered into lease and rental financing arrangements, often with government-established public authorities that issue bonds and construct facilities that are leased back to the government. These arrangements are sometimes used as a means of circumventing restrictions on public bidding and incurrence of debt, of financing unpopular projects, or for other reasons. Proper reporting of these arrangements requires the auditor to understand the relationship of governmental entities and public authorities, the terms of the financing agreement, and state and local laws. For example, some courts have ruled that the related debt is general obligation debt of the governmental entity, while others have ruled that it is not general obligation debt.

GASB Codification Section L20.119–124 provides guidance on accounting for and reporting lease agreements between governmental entities and public authorities. In March 1990, the GASB issued an exposure draft of a proposed Statement of Governmental Accounting Standards, *The Financial Reporting Entity,* that would supersede GASB Codification Section 2100, "Defining the Reporting Entity," and provide additional guidance on this topic.

Self-Insurance Arrangements and Incurred-But-Not-Reported (IBNR) Claims

Self-insurance arrangements have become increasingly popular as a result of increases in premiums charged by insurance companies. These arrangements typically provide employee medical, workers' compensation, vehicle collision, general liability, and property insurance. Government funding of many of these self-insurance risks is often determined based on available resources rather than on sound actuarial methodologies and assumptions. In such cases, a government may have inadequate reserves to cover catastrophic losses.

Also, improper accounting for IBNR claims may result in underreporting of liabilities and inadequate disclosures.

Guidance on accounting and reporting self-insurance activities and IBNR claims can be found in chapter 10 of the AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units,* and GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues.*

Reporting Issues

Single Audits

Single audit reporting issues continually arise as a result of changing professional standards and federal regulations. Several single audit reporting issues that are frequently encountered are discussed in the following pages.

Reporting on Compliance With Laws and Regulations—Nonmajor Programs. A report on compliance with laws and regulations related to nonmajor programs should be issued for all audits *unless* major programs exceed 50 percent of total expenditures *and* no transactions from nonmajor programs are selected by the auditor in any other audit test work.

Reporting Instances of Noncompliance. When issuing a report on compliance with laws and regulations applicable to federal financial assistance programs, *all* instances of noncompliance need to be reported. Materiality is not a consideration in deciding whether to report instances of noncompliance when reporting in accordance with the Single Audit Act and OMB Circular A-128, *Audits of State and Local Government.*

Reporting on Internal Controls. When issuing a report on internal controls as required by *Government Auditing Standards* (example 25 in SOP 89-6), the auditor should present a list of the significant internal controls including the controls established to ensure compliance with laws and regulations that could have a material impact on the financial statements. These controls may include accounting controls as well as controls over the general and specific compliance requirements.

Although it may not be appropriate in all circumstances to include a description of the controls related to the general and specific requirements in the report, auditors reporting in accordance with the *Government Auditing Standards* or the Single Audit Act need to consider these controls for inclusion. The decision on whether to include that description should be based on whether noncompliance with a general or specific requirement could result in a material error in the financial statements.

The "50% Rule." The 50% rule discussed in paragraph 21.12 of *Audits of State and Local Governmental Units* applies *only* to understanding and assessing the internal control policies and procedures used in administering federal financial assistance. It does *not* apply to the testing of compliance with laws and regulations (which is, by definition, a substantive test). An exposure draft of an AICPA Statement of Position, *The Auditor's Consideration of Internal Controls Over Federal Financial Assistance Programs Under the Single Audit Act,* issued in March 1990, addresses how the auditor should perform tests of controls in order to satisfy the 50% rule. Guidance is also found in a column in the *Journal of Accountancy* entitled "For the Practicing Auditor" (Patrick McNamee, ed., May 1990 [New York: AICPA], 110-115) and in PCIE Statement No. 2.

The PCIE Standards Subcommittee publishes supplemental, nonauthoritative guidance for federal officials dealing with issues arising from the implementation of the Single Audit Act; OMB Circular

A-128, which implements the act; and OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Organizations,* which extends the single-audit concept to institutions of higher education and other nonprofit institutions.

The PCIE Standards Subcommittee has issued the following position statements:

- *PCIE Statement No. 1* provides guidance on determining when a series of audits of individual federal departments, agencies, and establishments may be considered an audit for purposes of the Single Audit Act.
- *PCIE Statement No. 2* provides guidance to cognizant agencies on determining whether an audit report that does not meet the 50% rule on internal control coverage prescribed in the AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units,* should be accepted.
- *PCIE Statement No. 3* provides guidance on using a cyclical approach to internal control reviews of nonmajor programs.
- *PCIE Statement No. 4* establishes uniform procedures for referrals of substandard audits to state boards of accountancy and the AICPA.
- *PCIE Statement No. 5* provides guidance for certain not-for-profit entities other than institutions of higher education or hospitals not covered by OMB Circular A-110, *Uniform Administrative Requirement for Grants and Other Agreements With Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations.*

Copies of PCIE Standards Subcommittee Position Statements can be obtained by calling the U.S. Department of Education, Office of Inspector General, at (202) 732-4798.

Reporting Entity

The concept of what constitutes the financial reporting entity of a governmental unit has been evolving and has become more complicated as governments create separate entities to provide regional services, to address debt restrictions, or for other reasons. Some of the entities and arrangements encountered include—

- Entities used to finance certificates of participation.
- Economic development vehicles.
- Joint ventures.
- Legally required funding.
- Public authorities.
- Research consortiums with government participation.

- Contingent liabilities (debt and other).
- Public entity risk pools.

In March 1990, the GASB issued an exposure draft of a statement dealing with this issue entitled *The Financial Reporting Entity* that would supersede GASB Codification Section 2100, "Defining the Reporting Entity," and provide additional guidance on this topic.

Condensed Financial Reporting

Condensed summary financial reporting is becoming a popular reporting method with certain governments. Condensed financial statements present a summary of all or some of the fund types and account groups maintained by the government. A common method is to present the financial statements for an entire government's operations in a single fund, usually on the accrual basis of accounting.

Oftentimes, the auditor is engaged or required by professional standards to report on condensed financial statements (for example, when the condensed financial statements are presented in an auditor-submitted document that contains audited financial statements and the auditor's report thereon). The form and content of the data presented and the nature of the document in which the data are presented generally dictate the reporting guidance to be followed.

Guidance on reporting on condensed financial statements and selected financial data is found in *AICPA Professional Standards,* AU Section 551, *Reporting on Information Accompanying the Basic Financial Statements in an Auditor-Submitted Document,* and AU Section 552, *Reporting on Condensed Financial Statements and Selected Financial Data.* Section 551 provides guidance on reporting on condensed financial statements or selected financial data that accompany audited financial statements in an auditor-submitted document. Section 552 provides guidance on reporting in a client-prepared document on condensed financial statements or selected financial data derived from audited financial statements.

While these AU sections allow certain reporting if condensed financial statements accompany general-purpose financial statements from which they were summarized, current auditing literature requires that an adverse opinion because of inadequate disclosure be rendered on condensed financial statements when they are presented as standalone statements.

Part of an Audit Performed by Other Independent Auditors

An AICPA staff interpretation of AU Section 543, *Part of Audit Performed by Other Independent Auditors,* AU Section 9543.21 states that it is not appropriate for the principal auditor of general-purpose financial statements to express an opinion on the financial statements of an individual fund audited by another auditor.

Accounting and Financial Reporting Standards

Measurement Focus and Basis of Accounting

The GASB is currently reexamining the basic concepts underlying governmental accounting and financial reporting. A fundamental step in this reexamination process was the issuance of GASB Statement No. 11, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements,* which is effective for financial statements for periods beginning after June 15, 1994. The extended effective date is necessary to allow adequate time for the GASB to develop, expose, and issue the other recognition, measurement, and financial reporting standards that will be necessary to completely implement the flow of financial resources measurement focus. GASB Statement No. 11 prescribes the flow of financial resources measurement focus for governmental fund operating statements. This statement provides guidance for balance sheet reporting of only general long-term capital debt; guidance for balance sheet reporting of other liabilities arising from or related to the operations of governmental funds will be provided in a subsequent GASB statement on financial reporting. As the GASB reexamines other areas of governmental accounting and financial reporting, additional statements will be issued.

Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds

GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting,* requires a statement of cash flows (instead of a statement of changes in financial position) as part of a full set of financial statements for all proprietary and nonexpendable trust funds and governmental entities that use proprietary fund accounting. It exempts Public Employee Retirement Systems (PERSs) and pension trust funds from the requirement to present either a statement of cash flows or a statement of changes in financial position.

This statement requires that a statement of cash flows classify cash receipts and payments according to whether they stem from operating, noncapital financing, capital and related financing, or investing activities, and it provides definitions of each category. Information about investing, capital, and financing activities not resulting in cash receipts or payments in the period is required to be provided separately.

This statement is effective for annual financial statements for fiscal years beginning after December 15, 1989. Restatement of financial statements for earlier years provided for comparative purposes is encouraged but not required.

Risk Financing and Related Insurance Issues

GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues,* establishes accounting and financial reporting standards for risk financing and insurance-related activities of state and local governmental entities, including public entity risk pools. The risks of loss that are included within the scope of this statement include torts; theft of, damage to, or destruction of assets; business interruption; errors or omissions; job-related illnesses or injuries to employees; acts of God; and any other risks of loss assumed under a policy or participation contract issued by a public entity risk pool. Also included are risks of loss resulting when an entity agrees to provide accident and health, dental, and other medical benefits to its employees. GASB Statement No. 10 generally requires public entity risk pools to follow the current accounting and financial reporting standards for similar business enterprises, based primarily on FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.*

The requirements of this statement that affect public entity risk pools are effective for financial statements for periods beginning after June 15, 1990. The requirements for entities other than risk pools are effective for financial statements for periods beginning after June 15, 1994.

Postemployment Benefits Other Than Pension Benefits

GASB Statement No. 12, *Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers,* requires the following disclosures to be made by all state and local governmental employers: (1) a description of the benefits provided, employee groups covered, and the employer and participant obligations to contribute; (2) a description of the statutory, contractual, or other authority under which benefit provisions and obligations to contribute are established; (3) a description of the accounting and financing or funding policies followed for those benefits; and (4) the expenditures or expenses for those benefits recognized for the period and certain related data.

Until the GASB has completed its project on recognition and measurement of postemployment benefits other than pension benefits, state and local governmental employers are not required to change their accounting and financial reporting of those benefits. This statement is effective for fiscal years beginning after June 15, 1990. Earlier application is encouraged.

Pension and Deferred Compensation Plans

The following accounting and reporting factors for government pension plans and deferred compensation plans should be considered:

- The type of pension plan and its inclusion as part of the reporting entity drives the disclosures that are required to be made. The three types of governmental pension plans are single employer, agent multiple employer, and cost-sharing multiple employer.
- Employers participating in single and agent multiple employer plans *are required* to present three-year historical trend information in the notes to the financial statements *and* certain ten-year information as required supplemental information (RSI). Only if another report (such as that of a Public Employee Retirement System or PERS) contains the ten-year information can the employer make a reference to that report in lieu of presenting the RSI. AU Section 558 should be followed when reporting on RSI.
- The calculation of pension benefit obligation in many instances is not the same as that of the actuarial accrued liability. The concept of the pension benefit obligation is important to understanding the government's overall pension situation and the ways in which it differs from the actuarial liability that may actually exist for the employer.
- Assets of deferred compensation plans established under Internal Revenue Code Section 457 should be valued at market value and reported in an agency fund.

Operating Leases

GASB Statement No. 13, *Accounting for Operating Leases With Scheduled Rent Increases*, establishes standards for accounting and financial reporting for operating leases with scheduled rent increases, regardless of the fund type used to report the lease transactions. It requires governmental entities to account for operating leases with scheduled rent increases by using the terms of the lease contract when the pattern of the payment requirements is systematic and rational. This includes lease agreements that specify scheduled rent increases over the lease term that are intended to cover economic factors relating to the property, such as the anticipated effects of cost increases or property value appreciation.

The provisions of this statement are effective for leases with terms beginning after June 30, 1990. Retroactive application for leases with terms beginning before July 1, 1990, is permitted.

References for Additional Guidance

AICPA

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 334-6961 (except New York) or (800) 248-0445 (New York only).

GASB

Copies of GASB publications may be obtained by calling the GASB Order Department at (203) 847-0700, extension 10.

Single Audit Information Service

The Single Audit Information Service is a looseleaf reference service offered by the Thompson Publishing Group. It explains how to implement the single audit and provides an update of current events in the governmental audit community. The Single Audit Information Service can be ordered by calling the Thompson Publishing Group at (202) 872-1766.

Federal Agencies—Administrative Regulations

The various federal agencies issue general administrative regulations that apply to their programs. These regulations provide general rules on how to apply for grants and contracts, how grants are made, the general conditions that apply to grantees and contractors, their administrative responsibilities, and the compliance procedures used by the various agencies. These regulations are included in the *Code of Federal Regulations*.

In 1988, a revised OMB Circular A-102, *Grants and Cooperative Agreements With State and Local Governments*, was published, establishing a "common rule" designed to create consistency and uniformity among federal agencies in the administration of grants to and cooperative agreements with state, local, and federally recognized Indian tribal governments. The common rule has been codified in each federal agency's portion of the *Code of Federal Regulations*.

It should also be noted that federal agencies have also codified OMB Circular A-128, *Audits of State and Local Governments*, in each agency's portion of the *Code of Federal Regulations*. Although OMB's *Compliance Supplement for Single Audits of State and Local Governments* provides the compliance requirements for programs contributing a great majority of funding to state and local governments, federal agencies also develop specific compliance supplements for use in auditing programs not included in the OMB document. These can be obtained directly from the regional office of the appropriate federal agency.

Auditors should also be aware that many agencies have program-specific and other audit requirements that are not covered by Circular A-128. Such requirements may relate to certain programs, such as student financial assistance or HUD-insured mortgage programs, as well as include contract audit requirements.

Federal Agencies—Audit Guides

Federal agencies issue audit guides for various programs and activities. These include, but are not limited to, the following:

- *Audit Guide for the Use of Independent Public Accountants in Audits of HUD-Approved Nonsupervised Mortgages, Loan Correspondents, and Co-Insuring Mortgagees*—The guide is prepared by HUD and is available from the Government Printing Office (GPO). Its stock number is 023-000-00718-5.
- *Audit Guide for the Use of Independent Public Accountants for Audit of Mortgagors Having HUD-Insured or Secretary-Held Multifamily Mortgages*—The guide is prepared by HUD and is available from the GPO. Its stock number is 023-000-00726-6.
- *Audit Guide—Audits of Student Financial Assistance Programs*—The guide is prepared by the U.S. Department of Education, Office of the Inspector General. It is available from the Office of the Inspector General, U.S. Department of Education, Washington, D.C., and from Offices of Regional Inspectors General for Audit.

General Accounting Office

GAO publications include:

- *Government Auditing Standards* (Yellow Book—1988 Revision)—The standards relate to audits of government organizations, programs, activities, and functions, and of government funds received by contractors, nonprofit organizations, and other nongovernment organizations. The standards incorporate the AICPA Statements on Auditing Standards but prescribe additional standards needed to meet the more varied interests of users of reports on government audits. The standards pertain to the auditor's professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports. These standards are available from the GPO, Superintendent of Documents, Washington, D.C. 20401. The stock number is 020-000-00243-3.
- *Assessing Compliance With Applicable Laws and Regulations*—This booklet, issued by the GAO Office of Policy, is intended to help the auditor implement strengthened requirements for detecting noncompliance. Requests for copies of this booklet should be sent

to: U.S. General Accounting Office, P.O. Box 6015, Gaithersburg, MD 20877. The telephone number is (202) 275-6241. The number and publication date are GAO/OP-4.1.2 and December 1989, respectively.

Office of Management and Budget—Circulars

The OMB, in consultation with grant-making agencies, the GAO, and representatives of grant recipients, developed a series of financial circulars that establish uniform policies and rules to be observed by all executive branch agencies of the federal government. Circulars relevant to audits of state and local governmental units are listed below. For copies of circulars, call the Executive Office of the President, Publications Office, at (202) 395-7332.

OMB Circulars Relevant to Audits of State and Local Governments

Circular Number	*Applicability*	*Issue Date*
A-50 (Revised)	Audit follow-up	September 29, 1982
A-73 (Revised)	Audit of federal operations and programs	June 20, 1983
A-87 (Revised)	Cost principles for state and local governments	January 15, 1981
A-102 (Revised)	Grants and cooperative agreements with state and local governments	March 3, 1988
A-128	Audits of state and local governments (see also related questions and answers document under "Other OMB Guidance" on next page)	April 12, 1985

Office of Management and Budget—Other Guidance

Other documents issued by the Office of Management and Budget that have accounting and auditing applications are listed below.

- *Catalog of Federal Domestic Assistance*—The *Catalog* is a government-wide compendium of federal programs, projects, services, and activities that provide assistance or benefits to the American public. The General Services Administration (GSA) is responsible for the dissemination of federal domestic assistance information through the *Catalog* and maintains the information data base from which program information is obtained. The OMB serves as an intermediary between other federal agencies and the GSA, thus providing oversight relative to the collection of federal domestic assistance program data.

Program information provided by the *Catalog* includes authorizing legislation and audit requirements. The GSA distributes copies to certain specified national, state, and local government offices. *Catalog* staff may be contacted at (202) 708-5126. Private individuals must write the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402, or call (202) 783-3238.

Program information is also available on machine-readable magnetic tape. The tape may be purchased by writing the Federal Domestic Assistance Catalog Staff, General Services Administration, Ground Floor, Reporters Building, 300 7th Street, S.W., Washington, D.C. 20407, or calling (202) 708-5126.

- *Compliance Supplement for Single Audits of State and Local Governments*—The *Compliance Supplement* sets forth the major federal compliance requirements that should be considered in a single audit of state and local governments that receive federal assistance. It supplements OMB Circular A-128, *Audits of State and Local Governments*. Information regarding the *Compliance Supplement* may be obtained by contacting the OMB Financial Systems and Policy Branch at (202) 395-3993.
- *Questions and Answers on the Single Audit Provisions of OMB Circular A-128, Audits of State and Local Governments*—This document provides guidance relative to the single audit process through a series of questions and answers. The document is available from the Executive Office of the President, Publications Office, at (202) 395-7332.
- *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments (Common Rule)*—This document, as revised and adopted by the various federal agencies, is available by reference to the *Federal Register*, vol. 53, no. 48 (Friday, March 11, 1988).

Government Finance Officers Association

The GFOA's address and telephone number are: 180 N. Michigan Avenue, Suite 800, Chicago, IL 60601-7476; (312) 977-9700. Its publications include:

- *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*—The GAAFR provides nonauthoritative guidance on the practical application of generally accepted accounting principles for governments. It includes implementation guidance on the many pronouncements of the GASB, detailed journal entries and explanations that cover a multitude of common and complex transactions, a complete sample comprehensive annual financial report, discussion and illustration of single audit requirements, a glossary and chart of accounts, and a detailed index. (The *GAAFR Study Guide* is also available.)

- *Audit Management Handbook*—This handbook on audit management is intended for state and local governments and CPA firms that are involved in obtaining or performing financial audits. It provides information on all aspects of the audit management process, including establishing the scope of the audit, audit procurement (including model requests for proposal), monitoring the audit, and resolving audit issues and findings.
- *Financial Reporting Series*—This set of books contains information and examples on how governments present specific financial reporting information. It includes—
    1. *Illustrations of Notes to the Financial Statements of State and Local Governments.*
    2. *Illustrations of Introductory Sections of Comprehensive Annual Financial Reports of State and Local Governments.*
    3. *Illustrations of Statistical Sections of Comprehensive Annual Financial Reports of State and Local Governments.*
    4. *Illustrations of Supplementary Financial Data in Comprehensive Annual Financial Reports of State and Local Governments.*
    5. *Illustrations of Interim Financial Statements of State and Local Governments.*
    6. *How to Understand Local Government Financial Statements: A User's Guide.*
    7. *Illustrations of Combined, Combining, and Individual Fund and Account Group Financial Statements of State and Local Governments.*
    8. *Suggested Solutions to Governmental Accounting and Financial Reporting Practice Problems in Applying Authoritative Standards.*
    9. *Illustrations of Popular Reports of State and Local Governments.*
    10. *A Public Manager's Guide to Government Accounting and Financial Reporting.*
- *GAAFR Review*—This monthly newsletter covers major issues in governmental accounting, auditing, and financial reporting and includes analyses of recent authoritative pronouncements in the field. In addition, it provides nonauthoritative guidance related to technical inquiries and focuses on current areas of interest in governmental accounting.

Audit Risk Alert—1989*

General Update on Economic, Industry, Regulatory, and Professional Developments

Introduction

This alert is intended to help you in planning your 1989 year-end audits. Successful audits are a result of a number of factors, including acceptance of clients with integrity, adequate partner involvement in planning and performing the audit, an appropriate level of professional skepticism, and allocating sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of new professional standards and current developments in business and government.

This alert identifies areas that, based on current information and trends, may affect audit risk on many 1989 year-end audits. Although it isn't a complete list of risk factors to be considered, and the factors listed won't affect risk on every audit, you can use this alert as a planning tool for considering factors that may be especially significant for 1989 audits.

Expectation-Gap SASs

The Auditing Standards Board issued nine Statements on Auditing Standards (SASs)—Nos. 53-61—that are commonly called the expectation-gap SASs. Except for SAS No. 55 on internal control, all are effective for calendar-year 1989 audits (SAS No. 55 becomes effective next year); they all impose a number of new requirements. This summary highlights the new requirements that are expected to have the greatest effect on your audits. Remember though, this alert presents only highlights; there's a lot more material in the actual SASs that you'll need to consider in planning, performing, and reporting on your 1989 audits.

New Planning Requirements

Misstatements. SAS No. 53 restates the auditor's responsibility for detecting material misstatements. It requires the auditor to design the audit to provide *reasonable assurance of detecting errors and irregularities that are material* to the financial statements.

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Identifying Illegal Acts. SAS No. 54 changes the auditor's responsibility for detecting illegal acts. It says that the auditor's responsibility for detecting illegal acts that have a direct and material effect on the financial statements is the *same as for detecting material errors and irregularities* (see the item on SAS No. 53, above). The auditor's responsibility for identifying illegal acts with only an *indirect* effect on the financial statements differs: the auditor must be aware that such illegal acts may have occurred and follow up when they have been identified, but is not required to design the audit to detect these other illegal acts. (Certain types of illegal acts that may be of concern in 1989 audits are discussed later in this alert.)

Required Analytical Procedures. SAS No. 56 requires the application of analytical procedures in *planning* the audit. These procedures are intended to enhance the understanding of the client's business and activities and to identify areas of specific risk.

Auditing High-Risk Areas. The auditor should design the audit approach based on an assessment of risk. (See SAS No. 53.) The auditor should respond to increased risk of material misstatement by—

a. Assigning more experienced personnel to the engagement or increasing the level of supervision.
b. Changing the nature, timing, or extent of planned audit procedures.
c. Exercising a higher degree of professional skepticism.

New Performance Requirements

Heightened Professional Skepticism. SAS No. 53 says that the auditor should perform the audit with an attitude of professional skepticism—assuming *neither* management honesty nor dishonesty. This is an important change. The previous standard (SAS No. 16) assumed management integrity in the absence of evidence or circumstances to the contrary.

Required Analytical Procedures in Evaluation. SAS No. 56 requires that analytical procedures be applied at the *overall review* stage of the audit to assess the conclusions reached and the overall financial statement presentation.

Evaluating the Going-Concern Assumption. SAS No. 59 requires the auditor to evaluate in *every audit* whether there is a substantial doubt about the client's ability to continue as a going concern for one year beyond the balance sheet date. If, after considering information about management's plans for the future, a substantial doubt about the ability to continue remains, the auditor would add an explanatory paragraph to the audit report *regardless* of whether the assets and liabilities are appropriately valued or classified.

New Communication Requirements

New Auditor's Report. SAS No. 58 requires a new form of standard auditor's report.

Communication of Irregularities and Illegal Acts. SAS Nos. 53 and 54 require communication of all irregularities and illegal acts, except inconsequential ones, to the client's audit committee or, when the client doesn't have an audit committee, to persons with equivalent authority and responsibility, which, in a small business, may be the owner-manager.

Reporting Control Weaknesses. SAS No. 60 requires the auditor to report significant control weaknesses to the client, preferably in writing. SAS No. 60 sets a new benchmark for reporting on internal control: "*reportable condition*" replaces "material weakness."

Required Communications With Audit Committees. SAS No. 61 requires that certain matters be communicated whenever the client is a publicly held company *or* has an audit committee or oversight group, even if it's not public.

Applicability of SAS No. 63 on Compliance Auditing

Among other things, SAS No. 63 applies to reports on compliance with laws and regulations and internal control in engagements covered by government auditing standards (the GAO "Yellow Book"), but the *applicability is broader* than it might first appear. You may unexpectedly find yourself under government auditing standards and SAS No. 63.

Private Organizations

Due to federal laws, agency regulations, federal audit guides, and contractual agreements, the Yellow Book applies to *many private organizations*. For example, it might apply to the audit of a trade school because student financial aid is provided by the U.S. Department of Education, to a construction company because of financial guarantees provided by HUD, or to a financial institution because it processes government-guaranteed loans.

State Agencies

Some states have adopted the Yellow Book for all audits of their political subdivisions or agencies.

Illegal Acts

Certain types of illegal acts recently have caused audit concerns.

Environmental Issues

The reach of the federal Superfund legislation is greater than it might first appear. Under that law, anyone who ever owned or operated a hazardous waste site or generated or transported hazardous material to the site may be held responsible for cleaning it up. Thus, for example, a client that acquires through foreclosure property designated a hazardous waste site can be held responsible for the cleanup *even if it had nothing to do with creating the waste* or if the waste was present when the property was acquired.

Independent Contractors

The IRS has stepped up enforcement against abuses in classifying workers as independent contractors, rather than employees. Misclassification of workers as independent contractors may misstate the employer's liability for employment taxes and lead to *fines or penalties*.

Governmental Investigations

Recent governmental inquiries and investigations into some industries and practices (such as defense contractors or insider trading) may result in legal or regulatory challenges to customs or practices previously accepted in an industry.

Questionable Accounting and Fraudulent Financial Reporting

In recent years, the following situations have resulted in misstatements that auditors failed to detect. Consider whether they apply to your clients.

Revenue Recognition Issues

- Improper sales cutoffs
- Recording sales under bill-and-hold agreements, which cast doubt on whether a sale actually has taken place
- Recording as sales shipments to third parties "authorized" to accept goods on behalf of buyers
- Recording sales with written or oral rights of return when the chance of such return is not remote

- Treatment of operating leases as sales
- Nonrecording of sales returns
- Improper application of the percentage of completion method
- Undisclosed "side agreements" on sales, leases, etc.

Other Accounting Matters

- Improper deferral of costs
- Improper off-balance-sheet financing or transactions designed to disguise the substance of the transactions—especially when there are undisclosed "side agreements"
- Changing inventory count sheets

Red Flags of Possible Misstatements

- Unusually heavy sales volume near the end of the year
- Transactions that seem unnecessarily complex
- Aggressive growth of a company with a poor internal control structure
- Growth in sales or earnings shortly before an initial public offering

Highly Leveraged Companies (Including LBOs) and Holders of Junk Bonds

If you audit highly leveraged companies, such as those resulting from leveraged buyouts (LBOs), or clients that hold junk bonds, you may face these audit risks.

Highly Leveraged Companies

An economic slowdown in the client's industry or geographic area could strain the company's liquidity or cause loan covenant violations. In those cases, auditors need to consider: amounts and classification of liabilities; going-concern issues (the auditor's new responsibility for evaluating going concern was discussed earlier in this alert); and the entity's plans (such as asset dispositions or deferral of expenses) and their effects on operations, in light of expected economic conditions.

Holders of Junk Bonds

The market value of junk bonds may be affected by current events, such as extreme market fluctuations and new requirements for savings and loan institutions to dispose of their junk bonds. The value of the bonds may depend entirely on the creditworthiness of the issuer and the holder's ability to keep the bonds until maturity.

Loan Agreements

Current lending practices may affect classification of debt for clients that depend on credit provided by others.

Due-on-Demand Clauses

Some debt agreements have due-on-demand clauses even though future maturity dates are stated.

Subjective Acceleration

Some debt agreements have covenants that accelerate debt payments based on subjective criteria, such as "material adverse changes." Adverse developments in the financial-services industry or the economy may cause lenders to judge these criteria differently than in the past and seek to exercise their rights under these covenants.

Specialized Industries

While most of the items in this audit risk alert affect clients in many industries, there have been developments in specific industries that you may need to be aware of.

Financial Institutions

Recent congressional testimony and other developments indicated that risk may be increased in the following areas this year:

- Negative effects of local economies on real estate values and the resulting effects on the collateral underlying real estate loans and on collectibility of the loans
- Weak underwriting policies and procedures (particularly for home-equity loans) and their effect on ultimate collectibility
- Transactions that appear to lack economic substance

- Carrying value of securities
- Adequacy of allowances for credit losses on loans to less-developed countries (guidance is provided in the AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks*—product number 021050)

Pension Plans

A recent Department of Labor report disclosed findings that many independent auditors of employee benefit plans' financial statements failed to follow the AICPA guide *Audits of Employee Benefit Plans* and failed to properly disclose known violations of ERISA regulations. The report also noted that benefit plans' poor internal controls have led to understatements of employer contributions, improper disbursement of plan assets, and excessive administrative costs.

Current Environments in Specialized Industries

The AICPA has prepared four other updates that address the current environments in the savings and loan, credit union, property and liability insurance, and health care industries; each of these contains this audit risk alert as an appendix.

Savings and Loan Industry Developments—1989 (product number 022051), *Credit Union Industry Developments—1989* (022053), *Property and Liability Insurance Industry Developments—1989* (022054), and *Health Care Industry Developments—1989* (022052) are available from the AICPA order department at $2.50 each; $2.00 to members. Additional copies of this audit risk alert are also available in a separate booklet, *Audit Risk Alert—1989* (022050), at $2.00 each; $1.60 to members. Telephone orders can be placed by calling (800) 334-6961 (US), (800) 248-0445 (NY).

Recurring Audit Problems

Certain problems have been identified in more audits than others. Some areas where auditors may fall short are described below.

Attorney Letters

Attorneys' replies to requests for information about litigation, claims, and assessments at times appear complete but in actuality contain vague or ambiguous language and are of little real use to the auditor. (An auditing interpretation of SAS No. 12 at AU 9337.18 in the AICPA *Professional Standards*, vol. 1, discusses what constitutes an acceptable reply and what to do when an unacceptable reply is received.) Also, replies may not be dated sufficiently close to the date of the audit report; additional inquiries may be needed.

Audit Programs

Written audit programs are required in all audits. They help your staff understand the work to be done and—together with other working papers—help you evaluate whether work has been performed adequately and whether the results of that work are consistent with the conclusions reached. It's important to be sure your audit programs are *adequately tailored* to reflect each *client's circumstances* and areas of greater *audit risk*.

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Technical Hotline

The AICPA Technical Information Service answers AICPA members' inquiries about specific audit or accounting problems.

Call toll-free: (800) 223-4158 (Except New York)
(800) 522-5430 (New York Only)

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